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SOX-RELATED DODD-FRANK AMENDMENTS

Dodd-Frank's SOX whistleblower protections supercharge compliance/litigation equation

From a compliance perspective, 2010 was a remarkable year. Among the landmark legislation wrought through Congress was the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173). Signed by President Barack Obama on July 21, the new law enacted a broad package of financial industry reforms that includes significant changes for employees who pursue claims under the whistleblower provisions of the Sarbanes-Oxley Act of 2002 (SOX). It is imperative that employers, as well as inside and outside counsel, understand the implications of these changes and how they impact compliance functions, document-retention policies, and the litigation landscape.

Inside

The Dodd-Frank Act's expansion of SOX-related whistleblower protections and the implications of these changes for employers and inside and outside counsel are the subject of comments by the co-chairs of Seyfarth Shaw LLP's national SOX Whistleblower Team:

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Brief tour of the SOX-related Dodd-Frank amendments

The Dodd-Frank Act creates a private right of action that, among other things, allows for expanded remedies for violations of the whistleblower provisions of SOX, while keeping the current remedies and enforcement scheme of those whistleblower provisions of SOX largely intact. However, Section 922(c) of the Dodd-Frank Act does amend SOX to increase the administrative complaint filing period, to clarify a right to jury trial, and to bar the use of predispute arbitration agreements. Dodd-Frank's Section 922(a) also amends the Securities Exchange Act of 1934 by adding a new section (21F) entitled "Securities Whistleblower Incentives and Protection."

Private right of action for securities whistleblowers includes SOX claims. In addition, the Securities Exchange Act's new Section 21F prohibits employers from discharging, demoting, suspending, threatening, harassing (directly or indirectly) or otherwise discriminating against an employee for:

(1) providing information to the SEC in accordance with Section 21F;

(2) assisting in an investigation or judicial or administrative action relating to the information provided, or

(3) making disclosures that are required or protected under SOX, the Securities Exchange Act or any other law, rule or regulation subject to the jurisdiction of the SEC.

Employees alleging violations of this new law may bring an action in the appropriate US district court. Such claims may not be brought more than six years after the violation complained of by the whistleblower has occurred, or more than three years after the employee knew or reasonably should have known about the facts material to their claim or, in any event, more than ten years after the date on which the violation occurred.

Relief for prevailing employees under the new law includes reinstatement, double back pay plus interest, and attorneys' fees and litigation costs.

SOX filing period increased. While Dodd-Frank keeps the enforcement mechanism for the whistleblower provisions of SOX largely intact, it does contain some significant amendments to SOX. First, under Section 922(c), aggrieved employees now have 180 days to file a complaint with the Department

of Labor's Occupational Safety and Health Administration (OSHA), an increase over the 90-day filing period previously provided under SOX. Moreover, the clock on the timely filing period now starts on the date on which the violation occurs or on the date on which the employee became aware of the violation. Prior to the amendment, the clock started on the date on which the violation occurred, regardless of when the employee became aware of it.

Right to jury trial added. Section 922(c) also amends SOX to expressly provide that employees bringing claims under SOX have a right to jury trial. Previously, at least one court had ruled that a SOX plaintiff was not entitled to a jury trial under SOX because the statute did not expressly provide for such a right (*Murray v TXU Corp*, NDTex, 86 EPD ¶41,981 (2005)).

Predispute arbitration agreements prohibited. Perhaps most significantly, Section 922(c) amends SOX to expressly prohibit the use of predispute arbitration agreements for SOX claims. Not only do the amendments specifically provide that the rights granted under SOX "may not be waived by any agreement, policy, form, or condition of employment, including by a predispute arbitration agreement," but the amendments contain a separate, specific provision stating that "[n]o predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under [the whistleblower provisions of SOX]."

Employee coverage clarified. Prior to the amendments, SOX covered only employees who work for a publicly traded company or brokerage firm, or for contractors, subcontractors, or agents of publicly traded companies. Section 922(b) of Dodd-Frank expands SOX coverage to include employees of "nationally recognized statistical rating organization[s]." In addition, Dodd-Frank's Section 929A amends SOX to clarify that the whistleblower protection provisions of SOX apply to employees of subsidiaries of publicly traded companies "whose financial information is included in the consolidated financial statements of [a publicly] traded company." At least one federal court had held that SOX's protection for whistleblowers was limited to employees of publicly traded companies and did not extend to the subsidiaries of publicly traded companies (*Rao v Daimler Chrysler Corp*, EDMich, 89 EPD ¶42,814 (2007)).

New Sec. 21F expanded whistleblower remedies, time limits. Even with the new amendments to SOX made by Dodd-Frank, it appears an employee bringing an action under the Securities Exchange Act's new Section 21F for violations of SOX has greater remedies and more time to bring a claim than if the employee brought a similar action under the remedies set forth in SOX. Both SOX and the Securities Exchange Act Section 21F allow prevailing employees to seek reinstatement and attorneys' fees and costs as remedies for SOX violations, but Securities Exchange Act Section 21F allows for double back pay plus interest, while SOX allows only for back pay plus interest.

Moreover, it appears that whistleblowers choosing to sue under the Securities Exchange Act Section 21F can seek remedies for violations of SOX while bypassing SOX's requirement to exhaust administrative remedies with the Department of Labor before going to court. Also, SOX, as amended by Dodd-Frank, requires aggrieved employees to file a complaint with OSHA within 180 days of the alleged violation or of when the employee became aware of the violation, while the Securities Exchange Act Section 21F allows a whistleblower to bring a court action up to three years after becoming aware of the claim, or six years after the violation has occurred (provided the claim is brought within ten years after the date of the violation).

Employees have a tremendous incentive to quietly gather information and take it directly to the SEC rather than participate in the SOX-mandated internal whistleblower programs.

What these changes mean for employers

To identify some of the important implications of these SOX-related Dodd-Frank amendments, CCH reached out to Attorneys Steven J. Pearlman and Christopher F. Robertson, co-chairs of Seyfarth Shaw LLP's national SOX Whistleblower Team.*

CCH: What are the compliance implications of the expanded SOX whistleblower protections for employers and their inside/outside counsel?

Dodd-Frank's recent amendments to the whistleblower protection provisions in Section 806 of SOX significantly heighten the risks that employers already faced and complicate and underscore the duties of their in-house and outside counsel alike in the following ways.

More employees covered, requiring stepped-up compliance function. First, the Dodd-Frank amendments dramatically increase the scope of employees who are eligible to file SOX whistleblower claims by amending Section 806 to expressly cover employees of private subsidiaries and affiliates of publicly traded companies whose financial information is included in its consolidated financial statements. Prior to the amendment, the majority of federal courts and U.S. Department

*Interview questions and answers have been consolidated due to space constraints.

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of Labor (DOL) decisions held that Section 806 was limited to publicly traded companies, with limited exceptions (*e.g.*, where a publicly traded company had a direct hand in making an alleged retaliatory decision with respect to an employee at its private subsidiary).

As a result, newly covered private entities need to step up their compliance programs and develop tools and techniques for defending those claims. In particular, many newly private companies that are covered by Section 806 now need to institute help lines, audit committees, policies and procedures addressing the treatment of whistleblowers and investigations, and training programs.

Longer limitations period, more adjudications on the merits. Second, Dodd-Frank doubles Section 806's original 90-day statute of limitations. Scores of complaints were dismissed based on the 90-day statute of limitations, so we can expect more cases to have longer lives and be adjudicated on the merits. Moreover, the passage of 180 days may pose practical problems for employers, as they lose the opportunity to more quickly respond to complaints and quickly institute appropriate remedial measures. Likewise, the greater passage of time that this increase in the statute of limitations allows leads to the fading of witnesses' memories and the potential loss of evidence.

Jury trial right heightens financial risk to employers. Third, Dodd-Frank now ensures that SOX whistleblowers have a right to a jury trial in cases that are kicked out to federal district court before the DOL issues a final order. Prior to this amendment, the law was unsettled as to whether SOX whistleblowers were entitled to a jury trial, and some decisions supported the argument that no such right existed. Of course, jury trials substantially heighten the financial risks to employers; they carry an inherent element of uncertainty and higher awards.

Arbitration agreement ban unfavorable for employers. Fourth, Dodd-Frank now prohibits predispute agreements requiring SOX claims to be arbitrated. This, too, is unfavorable to employers, especially because such agreements kept sensational fraud allegations out of the public eye. Likewise, employers will lose the cost-savings and speedy processes they enjoyed through arbitration.

CCH: How are employers and their inside/outside counsel impacted, in terms of compliance, by the additional protection SOX whistleblowers are afforded under the new Securities Exchange Act Section 21F?

Direct filing in federal court permitted. Unlike SOX's whistleblower framework, which requires employees to exhaust administrative remedies by first filing a claim with the DOL, Section 21F allows an employee to file a claim directly in federal court if he or she suffers retaliation for complaining to the U.S. Securities and Exchange Commission (SEC).

Employees have a very long time to file claims. Perhaps even more significantly (from a compliance perspective), Section 21F has an extraordinarily long statute of limitations period. It allows employees to file claims up to six years after the violation occurred, or three years after they knew or reasonably should have known of facts material to the violation, so long as the complaint is filed within ten years of the violation. By contrast, under Section 806, which now has a 180-day statute of limitations period, an employer could essentially "close" the employee's file with some degree of comfort after a year following termination (factoring in state and federal whistleblower and antiretaliation laws and common law retaliation claims).

Review document-retention policies. As a result, employers now must review their document-retention policies and confirm that applicable files are maintained for a significantly longer period than had previously been required. Likewise, employers must maintain files related to a departing employee's job responsibilities in addition to the human resources files relating to termination and defending against a retaliation claim. This is because an employee may go directly to the SEC with information about alleged misconduct, and the company may not know that the SEC has commenced or will be conducting an investigation. The loss of such information could compromise the company's defenses and even raise an inference that the employee's claims are meritorious.

CCH: What is the interplay between SOX whistleblower protection and the SOX-related Exchange Act whistleblower protection, especially with regard to when claims may be brought, available remedies, and incentives to blow the whistle?

Unlike Section 806 of SOX, the new Frank-Dodd whistleblower provisions, similar to False Claims Act cases, provide the employee with the potential to "share" in any recovery by the SEC over $1 million in connection with the underlying whistleblower claim. An employee may recover bounties of between 10-percent and 30 percent of the SEC's recovery. Those bounties could be enormous. One only need think about the size of the recent SEC recoveries from major financial institutions to understand the size of the potential award to a whistleblower. Even a 10-percent award could net a whistleblower millions of dollars.

Thus, employees have a tremendous incentive to quietly gather information and take it directly to the SEC rather than participate in the SOX-mandated internal whistleblower programs. Plus, an employee may wish to allow a problem to fester in hopes of achieving a greater recovery. Companies are struggling with how to continue to make their internal compliance programs viable, perhaps by offering competing incentives to bring concerns forward, and some of the comments to the

SEC's proposed regulations urge the SEC to require employees to attest that they first lodged their complaints internally before going to the SEC. This requirement would serve both purposes of the statutes, allowing companies to effectively investigate and take swift remedial steps while maintaining the anonymity that the Frank-Dodd's provisions seek to protect.

In addition, Section 21F now allows successful whistleblowers to obtain double back pay; SOX only provides for half of that remedy.

CCH: How do these new SOX-related provisions affect the litigation landscape?

More litigation expected. The Dodd-Frank amendments are likely to result in a spike in SOX whistleblower litigation by breathing life into claims that would have been time-barred under the original text of Section 806, presenting the specter of public litigation and jury trials, and offering private rights of actions to scores of new employees.

Employment litigation landscape changing. In addition, the proliferation of SOX whistleblower litigation is changing the landscape of employment litigation. Theories implicating nuanced securities law are being pursued by securities litigators in a space that previously was occupied almost exclusively by employment litigators. Expert testimony and analysis often is pursued when the parties delve into the merits of fraud claims. And parties are faced with complicated issues of first impression as this area of law is evolving.

Defense strategies must expand. As a result, defense counsel need to master all areas of SOX whistleblower defense, rather than simply resorting to a one-size-fits-all approach that solely focuses on the nonretaliatory reason why an employee was discharged. More specifically, in addition to focusing on employment retaliation issues, an effective defense strategy requires a sophisticated analysis of whether the plaintiff engaged in protected activity and had an objectively reasonable belief.

C-suite vulnerability, more media attention. We also expect to see more suits against executives in their individual capacities and that the plaintiffs' bar will play these cases out in the media. And we can expect to see more claims brought by higher-level employees. This means that potential back pay damages will be higher and that the cases may attract unwanted media attention.

CCH: What proactive steps should employers take to avoid having to defend against a whistleblower lawsuit?

Train managers how to respond to complaints. Training managers to understand how to respond to whistleblower complaints and identify risks is a must. In this regard, employers need to focus not only on minimizing the risk of actual retaliation against whistleblowers, but also on preventing whistleblowers from perceiving that they are being retaliated against. One important approach is to embrace good-faith whistleblowers as an asset to the company who could assist it in ferreting out fraud.

Implement a rapid-response system. Employers also need to develop rapid-response systems. To that end, employers should create SWAT teams comprised of employment and securities counsel, human resources, and compliance professionals in order to apply a thorough, multi-disciplinary approach when an internal whistleblower complaint is made. The approach should involve communications with the audit committee, a swift and comprehensive investigation, careful communications with the whistleblower, and appropriate disciplinary measures vis-à-vis individuals found to have engaged in fraud. Likewise, the approach should involve determining whether self-reporting to the SEC or other governmental agencies is warranted, as well as instituting remedial measures designed to eliminate any fraudulent conduct and abate its impact.

Maintain a culture of integrity and accountability. Further, on a macro level, employers need to develop a culture of integrity and accountability. This requires a top-down message with a heightened focus on transparency. Plus, employers should promulgate comprehensive codes of conduct and ethics that prohibit all types of fraudulent conduct and strongly encourage good-faith whistleblowers to come forward in order to protect the company and its shareholders. It is imperative that those policies include robust antiretaliation provisions, provide multiple channels for lodging complaints, and give employees the opportunity to complain anonymously.

Consider employee fraud certification, reward programs. Employers also should consider asking employees to complete forms, at regular intervals, certifying that they are unaware of any fraudulent misconduct or identifying the misconduct. In addition, employers should give thought to the option of rewarding employees who lodge internal complaints that prove to be well-founded. This option may be especially valuable to employers given that Dodd-Frank now offers substantial bounties to employees who complain to the SEC.

CCH: Are there any other insights related to the expanded SOX whistleblower protections that you would like to share for the benefit of employers or their inside/outside counsel?

As noted, to effectively defend SOX whistleblower cases and minimize the risk of those cases arising, employers need to take multidisciplinary approaches, rather than simply focusing just on the employment retaliation or securities angles. This requires employers to devote greater resources to their compliance function and to ensure that employment counsel and human resources professionals work together with securities counsel and compliance officers to develop comprehensive approaches. Further, employers need to put SOX whistleblower cases on the top of their radar, as they often invade the C-suite (note that Section 806 provides for individual liability), can severely damage a company's goodwill, and may compromise operations. In addition, as noted, companies need to develop document-retention policies that account for the exceptionally long statute of limitations in Dodd-Frank's new whistleblower provisions.